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No. 280

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968.

UNITED STATES OF AMERICA,
Petitioner,

v.

SKELLY OIL COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR SKELLY OIL COMPANY

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BRIEF FOR SKELLY OIL COMPANY

Opinions Below

The findings of fact, conclusions of law and decision of the district court (R. 20-30) are reported at 255 F. Supp. 228. The initial opinion of the court of appeals (R. 37-44) and the majority (R. 47-48) and dissenting (R. 49-54) opinions on rehearing are reported at 392 F.2d 128.

Jurisdiction

The initial judgment of the court of appeals was entered on April 20, 1967 (R. 45). The United States' petition for rehearing was granted on June 26, 1967 (R. 33, 46). The judgment on rehearing was entered on April 3, 1968 (R. 55). On July 2, 1968, an order was entered extending the time for filing a petition for a writ of certiorari to and including July 9, 1968. The petition was

filed on July 9, 1968, and was granted on October 14, 1968 (R. 56). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1). Respondent's brief on the merits is due to be filed on December 29, 1968.

Question Presented

Where respondent, a producer of natural gas, produced and sold the mineral during the years 1952 through 1957, and the sale price thereof entered into the computation of its depletion allowance, and in 1958, pursuant to a lawsuit, it was required to repay a portion of said sales price, does Section 1341(a)(4) of the Internal Revenue Code of 1954 require that its otherwise allowable ordinary and necessary business expense deduction or its otherwise allowable current year depletion deduction be adjusted so as to reflect the previously allowed depletion deduction?

Statute and Regulations Involved

Sections 162, 1341(a), and 1341(b) of the Internal Revenue Code of 1954 and the pertinent parts of Section 1.1341-1 of the Treasury Regulations on Income Tax (1954 Code) appear in the *Appendix*, infra, pp. 33-34.

Statement

Respondent, Skelly Oil Company, produces and sells natural gas in Oklahoma and was so engaged in 1952 when the Oklahoma Corporation Commission established a minimum price for sales of natural gas at the wellhead (R. 13-15, 21). This order raised the price of the gas respondent was selling under pre-existing contracts with Cities Service Company and Dorchester Corporation (R. 14, 22). The minimum price order was ruled invalid in *Michigan Wisconsin Pipeline Co. v. Corporation Commission of Oklahoma*, 355 U.S. 425 (1958), and was subsequently vacated (R. 14-15, 22).

In computing its depletion allowance for each of the years 1952 through 1957, Skelly had included in its "gross income" and in its "gross income from the property" the amounts charged under the invalidated minimum price order (R. 16, 17, 18, 23-25).

In 1958, Cities Service Company sued Skelly for $777,853.25, representing alleged overcharges for natural gas purchased by it from Skelly between August 1, 1952 and December 22, 1957. Also in 1958, Dorchester Corporation, which sold gas to Northern Natural Gas Pipeline Company of America for Skelly's account, was required, due to the invalidation, to repay Natural Gas Pipeline Company for alleged overcharges and it sought reimbursement from Skelly (R. 15, 17, 24-25).

In October and November, 1958, Skelly paid $5,536.54 to Dorchester Corporation and settled the lawsuit brought by Cities Service Company by paying Cities $500,000 (R. 15, 17, 23, 25). On its Federal tax return for 1958 Skelly took a business expense deduction for the $505,536.54 which it had paid to Dorchester and Cities Service (R. 18-19, 25-26).

Upon audit of Skelly's Federal tax return for 1958 the Internal Revenue Service reduced Skelly's otherwise allowable depletion allowance on its mineral production *for 1958* by $139,022.55, representing 27½ percent of the $505,536.54 deducted on the return. Skelly paid the resulting assessment and filed a claim and later a suit for refund (R. 25-26).

The only issue presented to the trial Court was whether, in computing Skelly's liability for Federal income tax for the taxable year ending December 31, 1958 under the provisions of Section 1341(a)(4) of the 1954 Internal Revenue Code, it was proper to reduce its otherwise allowable percentage depletion for the taxable year by $139,022.55 representing 27½ percent of $505,536.54, the purchase price received by it from the sale of natural gas

during prior taxable years, which purchase price had been included by it in gross income for such prior taxable years under a claim of right without restriction as to use, and which it was required to restore to the payors thereof during the taxable year ending December 31, 1958; or, in the alternative, whether Skelly was required to reduce its otherwise allowable deduction under Section 1341(a)(4) of $505,536.54 by 27½ percent, or $139,022.55, to reflect percentage depletion previously claimed and allowed thereon in its Federal income tax returns for the years in which such amount was taken into gross income under a claim of right without restriction as to use (R. 11, 12, 20-21).

The trial Court held that Skelly was entitled to a deduction in 1958 of only $366,513.99 on account of the $505,536.54 payment (R. 29-30), but the Court of Appeals unanimously reversed holding that no legal authority supported the decision (R. 37-44). After granting a rehearing, the Court of Appeals reiterated its prior decision with one judge dissenting (R. 47-54).

The United States filed a petition for certiorari on July 9, 1968, which was granted on October 14, 1968 (R. 56).

Summary of Argument

Prior to the enactment of the Internal Revenue Code of 1954 the "claim of right doctrine," based upon the concept of annual accounting for income tax purposes, was firmly established in the tax law. Under that doctrine if a taxpayer received income under claim of right, reported it in gross income in one year and in a later year was obliged to repay it or its equivalent, a deduction for the repayment could only be taken in the year of repayment. The application of the doctrine sometimes resulted in a burden and sometimes resulted in a benefit to the taxpayer.

In enacting Section 1341 of the Internal Revenue Code of 1954, Congress proposed to mitigate partially the stringent application of the "claim of right" treatment by establishing two alternatives, either of which would mandatorily apply depending upon which yielded the greater benefit to the taxpayer. Under the first alternative a *deduction* could be taken in the year of repayment for the amount repaid; under the second the *tax* for the year of receipt could be recomputed solely by excluding the amount repaid from the gross income of the year of original receipt.

Section 1341 applies if (1) an item was included in "gross income" for a prior taxable year or years under claim of right; (2) a deduction is allowable for the current taxable year because it was established after the close of the prior year or years that the taxpayer did not have an unrestricted right to such item; (3) the deduction exceeds $3,000; and (4) the deduction does not involve an item which was included in gross income by reason of the sale or disposition of stock in trade or property held primarily for sale to customers in the ordinary course of business, *unless* the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility if such refunds or repayments are required by a Governmental agency or by an order of a Court, or are made in settlement of litigation or under threat or imminence of litigation.

In the instant case the respondent met all the requirements for the application of Section 1341 and since no greater benefit was derived under either alternative, respondent was required to take the deduction in the year of repayment pursuant to subsection 1341(a)(4). The amount was included in "gross income" in the prior years, was restored in settlement of litigation and the amount involved exceeds $3,000. Although the natural gas was held for sale in the course of business, refunds on account of such sales were specifically included by Congress within the coverage of the Section.

The amount restored in 1958 was properly deducted on the return for said year as an ordinary and necessary business expense and not as a loss from one transaction. The transactional approach to the claim of right situation was rejected by this Court in *Healy* v. *Commissioner*, 345 U.S. 278 (1953), and by the Congress when Section 1341 was enacted. No "double deduction" is involved herein because the depletion deduction allowed or allowable in prior years was proper in said years, was a mandatory deduction, and was measured by "gross income from the property" and not "gross income." Although the depletion deductions to which respondent was entitled in prior years was determined by reference to the *gross income from the property*, the full amount later restored was included in *gross income* in the years of receipt—all that is required by the statute. The depletion deduction was allowed in prior years because the mineral was depleted; the deduction in the year here involved was occasioned by the payment of $505,536 as an ordinary and necessary business expense. Here, two separate and distinct events took place—the depletion of mineral and the payment of money. The cases which prohibit "double deductions" all involved two deductions for the same item. Where a deduction in the year of repayment is involved, Section 1341(a)(4) does not permit the prior year or years to be reconsidered or the *tax* for said years to be redetermined.

It is neither possible nor proper to create income in the taxable year of repayment by adding to gross income in the year of restoration an amount equal to the total depletion deduction taken in the prior several years when an amount equivalent to the amount restored was included in gross income. Such a procedure would call for the creation of an "inverse" tax benefit rule which is not and cannot be recognized under the law. The tax benefit rule itself does not apply because no benefit was bestowed upon respondent in the taxable year. To the contrary it *paid out* money. It recovered nothing.

Argument

A. Under the law in effect prior to the enactment of Section 1341 of the Internal Revenue Code of 1954, the judgment below is correct.

The most fundamental concept of tax law, and the essence of our system of taxation, is that income and deductions must be determined on an annual basis. The doctrine was established by this Court in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931), and further elaborated upon and strengthened in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417 (1932), *United States* v. *Lewis*, 340 U.S. 590 (1951), and *Healy* v. *Commissioner*, *supra*. Most recently, this concept was reaffirmed in *Commissioner* v. *Gordon*, 391 U.S. 83 (1968).

The annual accounting approach was established in *Burnet* v. *Sanford & Brooks Co.*, *supra*, because of its ease of application and its production of revenue at regular intervals. In doing so this Court specifically rejected the "transactional" approach or method which would postpone the assessment of the tax, until the transaction giving rise to income or deduction is finally concluded, to the end of a lifetime or for some other indefinite period.

In *North American Oil Consolidated* v. *Burnet*, *supra*, it was established that if a taxpayer receives income under claim of right he must report it as income even though it subsequently develops that its equivalent must be restored. *United States* v. *Lewis*, *supra*, established that in such circumstances, the taxpayer, if he was entitled to any deduction, was limited to a deduction of the amount restored only in the year of restoration. *Healy* v. *Commissioner*, *supra*, made it clear that the deduction must be the amount restored and is not to be limited to the *tax* paid when the restored item was originally received. It was recognized that the application of the rule could

result in either a benefit or a burden to the taxpayer or to the Government.

The issue before the Court is not really one of statutory construction or proper tax accounting as the petitioner contends. The statute is clearly written and the tax accounting rules have long been established. Respondent has contended, and the Court below has held, that the taxpayer here has applied the statute as Congress specifically intended it to be applied and has complied precisely with the rules of tax accounting long established by statute, regulation and judicial precedent. The real issue in the case is whether the Government may refuse to apply the statute and the accounting rules to this taxpayer because *it* believes that, in this particular year and with regard to this particular taxpayer, a windfall has been received. Regardless of the eventual economic outcome, and regardless of the long-term effect on other taxpayers or the Revenue Code itself, the petitioner proposes the adoption by this Court of a new "inverse tax benefit" rule which Congress itself refused to adopt. It is not enough to say that the tax rates in the years here referenced were essentially the same. Congress did not intend that subsection 1341(a)(4) would apply only when there had been a change in tax rates. If it had so intended, Congress would have said so.

In the present application of the revenue laws to adjustments between years rarely does either the Government or the taxpayer come out even at any given moment. Petitioner, however, would have this Court amend the law so that only taxpayers are penalized.

B. Section 1341 of the Internal Revenue Code of 1954 and its legislative history completely sustain the judgment of the Court below.

In enacting Section 1341 of the Code, it is clear that Congress was concerned only with partially adjusting the application of the so-called "claim of right doctrine" and was concerned only with the impact of the doctrine in one particular year. It was not concerned with the net economic aspects involving the receipt or payment of money over an extended period of time. In making such adjustment Congress had two choices: it could repudiate the annual accounting concept and adopt an "open transaction" doctrine under which a taxpayer would annually recompute and reevaluate its taxes on the basis of current developments as they affected all prior years and thus redetermine the net *tax* effect on a protracted or "open account" basis; or, it could provide a method of making a partial adjustment within the framework of existing law. It chose the latter by establishing two alternative but limited choices where a taxpayer received and reported income under claim of right and, due to later developments, was required to restore it.

Under the first alternative, a taxpayer could take a deduction in the year of restoration or repayment without reference to prior inclusion or exclusion. Section 1341(a)(4). Under the second alternative, he could compute the reduction in tax for the year of receipt which would result from the exclusion of the item from gross income. Section 1341(a)(5). The applicable alternative is to be determined by one test: which one yields the *greater tax benefit* to the taxpayer.

The intent of the statute is that a taxpayer may continue to determine his annual taxes within the context of the long-established "claim of right doctrine" by taking a *deduction* or, if the amount involved is large (exceeds $3,000) *and* the greater benefit is thereby obtained, the reduction in

tax for the prior year occasioned by excluding the amount received becomes the measure of the reduction of *tax* in the current taxable year. The only conditions established by the statute are that the amount exceed $3,000 and the amount restored has once been included in "gross income," a term of art in the tax law. Treasury Regulations Section 1.61-3(a). See, Revenue Ruling 60-344, 1960-2 Cum. Bull. 186. The taxpayer here complied with all of the conditions of the section and took the deduction as prescribed therein. Taxpayer was benefited thereby as Congress fully intended. See Congressional Committee Reports, Appendix, pp. 34-39.

Although the law is clear and unequivocal, the petitioner has sought to deny its application in this case, not by attacking the statute itself but by a scatter-shot attack on the equity of its application to this particular taxpayer in this particular instance by proposing an argument based on what it divines to have been the intention of Congress. To do this, however, it finds it necessary to not only distort Section 1341 but also to misconstrue other fundamental principles of tax law.

Contrary to the petitioner's assertion, Congress has never attempted to adjust *all* distortions occasioned by annual accounting principles and substitute an "open account" concept which would remove *all* inequities in the Revenue Code and equalize taxes paid from year to year as circumstances changed. Instead Congress has provided for *partial* amelioration of some of the most prevalent distortions and let the less common ones remain in the law regardless of whether the benefit or burden falls on the Government or the taxpayer. For an example of a circumstance where a taxpayer is burdened, see *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399 (Ct. Cls. 1967).

By the same token it is less than candid for the petitioner to attempt to justify its contention by blurring and softening the "claim of right doctrine" so as to imply that

it applies only when the original transaction is conditional. Until now it has always been the position of the Government that the doctrine applies only where a taxpayer receives income which is unequivocally his when received but *later developments* arising out of the circumstances of the original receipt require its restoration. The Government has repeatedly recognized this distinction and has used it to defeat the application of Section 1341 of the Code (which provides only a *partial* alternative to "claim of right"), by insisting that the Section only applies where some *subsequent* development occurs which deprives the taxpayer of an amount *equivalent* to that which he once included in gross income because it was then *absolutely* his. See Revenue Ruling 62-14, 1962-1 Cum. Bull. 11.

Neither are the petitioner's contentions supported by its argument based upon some mysterious and pseudo-sophisticated distinction between the terms "item" and "deduction" as used in the statute. The thrust of the argument is that the term "item" was intended by Congress to have a different meaning than the terms "amount" and "deduction."

The invalidity of this argument is illustrated by the petitioner's own statement on page 12 of its brief:

> "In section 1341(a)(1) the operative reference is to an 'item' which was included in gross income for the previous year. In this case, the *item* which was included in gross income in the previous year was the *amount* which was received for the sale of gas. If the word 'item' had been used in sections 1341-(a)(2), (4), and (5) it might be difficult to contend that the *amount* of the deduction which those provisions allow is different from the *amount* specified in section 1341(a)(1)." (Emphasis supplied.)

Respondent submits that the word "item" *is* included in Section 1341(a)(2)! That subsection ties together the words "amount" and "item" as follows:

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right *to such item* or to a portion of *such item*, * * *." (Emphasis supplied.)

The term "such item" can only refer to the *amount* included in gross income. Subsections (4) and (5) have no need to refer again to the "item" because they merely provide for the manner of handling the *deduction for the item* as described in subsections (1) and (2). The Revenue Service itself has always used and applied the terms "item" and "amount" interchangeably in this context. See, Revenue Ruling 58-226, 1958-1 Cum. Bull. 318.

It should be noted here that the petitioner, at p. 12 of its brief, where it purports to partially quote subsection 1341(a)(2), interpolates its own language into the quotation so as to avoid quoting the term "item" from the subsection. Respondent submits that the statute is as Congress wrote it—not as re-written by the petitioner. This substitution of paraphrasing language designed to create the impression that the statutory provision does *not* contain words which are, in fact, there, casts a shadow on the validity of petitioner's contentions in this case.

Regardless of this distortion of the statute, however, reference to the Congressional Committee Reports clearly shows that Congress intended to, and did, use the terms "amount" and "item" interchangeably in Section 1341. See House Report No. 1337, 83d Congress, 2d Session (1954), pp. 86, 87, A294, A295; Senate Report No. 1622, 83d Congress, 2d Session (1954), pp. 118, 451, 452. (Appendix, *infra*, pp. 34-39.)

Of course, the purpose of this distorted version of the law as presented by petitioner is clear. It is an attempt to engraft upon the statute and into the case law the "transactional approach" that Congress repudiated and this Court, in the past, has unfailingly rejected. Without this approach, however, the petitioner has no case.

Arrowsmith v. *Commissioner*, 344 U.S. 6 (1952), is inapposite here because only a transactional loss was involved in that case. There the taxpayer had in a prior year reported the gain from the liquidation of a corporation (one transaction) as a capital gain. In a subsequent year he was required to repay some of the amounts received and claimed an ordinary loss deductible in full. This Court held that the taxpayer was not in the trade or business of liquidating corporations and, hence, any loss deductible must be deducted as a capital loss. Otherwise the repayment would not have been deductible at all! The same distinction applies to the case of *O'Meara* v. *Commissioner*, 8 T.C. 622 (1948), where the taxpayer was required to take a loss deduction because it was finally determined that he had no title to the producing property itself.

Taxpayer here does not produce mineral on a transactional basis or as a "one-shot" proposition. It is in the trade or business of producing oil and gas for sale to customers in the ordinary course of business. No *loss* during the taxable year is involved. The Treasury Regulations under Section 165 specifically exclude from the purview of that section losses on account of inventory or stock in trade. Treasury Regulations Section 1.165-2. See, also, Treasury Regulations Section 1.471-2.

Respondent sustained a business expense by *paying out* $505,536. The payment did *not* occur because the mineral was not in fact depleted in prior years, but because taxpayer was required to pay out money in settlement of a law suit. The issue is obfuscated by the petitioner's insistence upon lumping together and equating the production of mineral and the depletion allowance on the basis of dollar amounts as if the business operations consisted of the production of dollars and not of mineral. This approach overlooks or ignores the fact that the depletion allowance is merely *measured* by dollars because that is the method prescribed by Congress.

The inapplicability of this new Government theory can be demonstrated by one question. If a producer of mineral receives no depletion deduction in a taxable year because of the taxable income limitations provided by Section 613 (a) of the Code, would the Government allow an additional depletion allowance in subsequent years when that limitation was greatly exceeded? In justice it should if its "open account" theory is correct and acceptable. We all know, however, that it will not because the depletion allowance is limited to 27½% of gross income from the property produced and sold in the *current taxable year*.

The fallacy of allowing the Government to interrupt in one year the orderly scheme of the revenue collecting process under the rules devised by Congress and the courts is illustrated clearly by reference to the adjustment proposed in this case. Here the Revenue Service adjusted downward the depletion deduction attributable to the current year's production, and to which the taxpayer admittedly was otherwise entitled, because of depletion properly taken in prior years. Taxpayer thus is deprived, in 1958, of the full depletion allowance to which it is otherwise entitled on account of its current production. Will the Government recognize this deprivation in a subsequent year if a taxable income limitation arises? In that event the Government would correctly maintain that the depletion deduction must be determined on an annual basis and without reference to financial aspects or occurrences in prior or subsequent years. So too, the taxpayer here correctly maintains that the Government may not ignore the annual accounting rules.

The core of the problem, insofar as this controversy is concerned, is that Section 1341 was never intended to operate in the manner which petitioner seeks to apply it. Hence petitioner must warp other sections of the Revenue Code in an attempt to obscure the clear purpose of Con-

gress. Ordinarily it would not attempt such a perilous adventure but it deems the "loophole" large enough to justify the attack. Admittedly Congress intended a benefit but the petitioner says, in effect, not this much. The real problem, however, is that the gas sold by respondent was held for sale to customers in the regular course of business. See Revenue Ruling 68-620, Internal Revenue Bulletin 1968-49, p. 6. In Section 1341(b)(2) Congress excluded sales of inventory or property held for sale to customers from the application of the section but deliberately and specifically included within its coverage refunds from such gas sales which, such as in the instant case, were required by a governmental body, a court order or in settlement of litigation, (Petitioner's Brief, p. 10, footnote 4.) See, Treasury Regulations Section 1.1341-1(f)(2). If it were not for this specific inclusive provision the section would not apply and the refunds here involved would be treated like any other inventory adjustment. It can hardly be presumed that Congress *unintentionally* legislated a benefit in this situation when it specifically provided for the inclusion of the payments here involved within the purview of the statute. The Senate Committee Report specifically states that refunds of charges for the sale of natural gas would be eligible for the benefits of this section. See, Senate Report No. 1622, 83d Congress, 2d Session (Appendix, pp. 36-39). In the circumstances it is obvious that Congress knew precisely what it was doing. If it had intended the adjustment sought by the petitioner it could have easily said so.

Inherent in the petitioner's argument is the proposition that subsection 1341(a)(4) is a legislative nullity and the supposedly "alternative" Section 1341(a)(5) is the only subsection to be applied in all cases. Respondent submits that Congress intended that Section 1341 be applied as written and that a taxpayer must select the one of two alternatives that produces the *lesser* tax. The section was

not designed to equalize the *tax!* If equalization were intended it could easily have been accomplished by legislating *only* subsection 1341(a)(5) and not enacting subsection 1341(a)(4). Instead, Congress enacted both subsections 1341(a)(4) and 1341(a)(5) and the petitioner is really asking this Court to rule subsection 1341(a)(4) *invalid* because, in petitioner's opinion, it allows a greater benefit than it would like to believe Congress intended.

C. The "Transactional Loss" argument proposed by petitioner avoids the issue in the case.

In its brief, pp. 14, *et seq.*, the petitioner states the issue as being confined to one of two distinct approaches; first, as a problem of determining the amount of a "loss" or, second, whether the previously allowed depletion deduction must be restored to income because of the prior tax benefit when events of a later year negative the basis for the earlier claim.

With regard to the "loss" question, the petitioner takes the position that the deduction referred to in Section 1341 of the Revenue Code must be determined under other sections of the Code *and* that Section 165(a), which provides for the deduction of any loss sustained during the taxable year is the applicable one. To quote petitioner's brief (p. 15) the proposition is that "Respondent may have its deduction only as allowed by this statutory provision." Admitting that many of the provisions of Section 165 relate to losses of capital assets, the petitioner proposes that Section 165(b) provides the "proper analogy for analysis of the present problem." Section 165(b), however, merely provides that the amount of a loss deduction shall be the adjusted basis provided in Section 1011 and that section contains no reference at all to a basis for a business expense *deduction*. It merely provides for the determination of the basis of *property* for the sole purpose of determining gain or loss from the *sale or other disposition* of

property. This defect in logic is emphasized in petitioner's brief by the casual observation that "In this case the loss is not capital in nature, but represents repayments of amounts received in the ordinary course of business" (Petitioner's Brief, pp. 15 and 16).

Respondent here has incurred no final loss which would invoke the application of Section 165. The fact is that the deduction involved in this case was taken under Section 162 of the Code which provides for the deduction of expenses incurred in the taxable year in carrying on a trade or business. It was so deducted on respondent's return and the petitioner agreed and stipulated in the Courts below that it was *properly* so deducted. That also happens to be the law. *Kornhauser* v. *United States,* 276 U.S. 145 (1928); *Welch* v. *Helvering,* 290 U.S. 111 (1933); *Commissioner* v. *Tellier,* 383 U.S. 687 (1966). There can be no dispute about that. The "loss" contention did not appear in this case until, in this Court, the petitioner alleged Section 165 to be the only applicable section of the Code, discussed it in its brief by "analogy," and then, in the same breath, conceded its inapplicability.

Thus the petitioner has injected an issue, pulled it back and proceeded to argue its shadow. The very next step is an expedition into the computation of the deductible "loss," which, petitioner admits, begins with the full amounts repaid and which had been previously included in "gross income." (Petitioner's Brief, p. 16.) This is precisely what Section 1341 provides! The section does not require the inclusion in *net* income or *taxable* income—only *gross* income. [At this point respondent respectfully requests the Court to consider carefully the discussion contained in footnote number 5 on page 16 of petitioner's brief. If there is such a thing in tax law as a "basis for a deduction," petitioner has conceded that that basis is obtained by including the amount in *gross income.*] Here respondent included the $505,536 in its *gross income* in the years 1952

through 1957. It paid out $505,536 in 1958 and deducted that amount as an ordinary and necessary business expense like any other business expense such as wages, salaries, operating expenses, etc. That is all that is required by Section 1341 or any other section of the Revenue Code. Although petitioner presents this argument in the name of equity it should be pointed out that under the law, except as provided by definitive statute, neither taxpayers nor the Government have ever been allowed to adjust a current year's tax computation in order to reconsider items *properly* reflected on the return for a different year. Even Section 165, by its terms, refers to losses *sustained during the taxable year.*

It is somewhat anomalous that petitioner can infer all kinds of narrow interpretations of the word "item" used in the Code, but, at the same time, refuse to recognize the long-established meaning of the term "gross income" which has been a term of special meaning in the revenue laws from their inception, and which has been explicitly defined by Treasury Regulations for a half century. See Treasury Regulations 45, Articles 31 to 49, inclusive, under Revenue Act of 1918 (1919).

Petitioner seeks to avoid the explicit terms and clear meaning of Section 1341, and the scope of the case law by using the terms "gross income" and "taxable income" interchangeably. But the distinction has long been inherent in the law. See, 5 Mertens, *Law of Federal Income Taxation* (1964 ed.), Section 28.13. Congress has been well aware of the distinction for many years and has legislated provisions that carefully take that distinction into account, such as the loss-carryover provisions of Section 172 of the Code. If it had intended that the deduction referenced in subsection 1341(a)(4) should be adjusted as petitioner contends, it would have so provided.

Congress was careful to spell out the applicable rules for recomputing *taxable income* when a taxpayer might be required to revert to the prior year for exclusionary purposes under subsection 1341(a)(5). Yet it made no reference to any such adjustments when a current year deduction was in order under subsection 1341(a)(4) of the Code. Presumably Congress meant precisely what it said—taxpayers might utilize whatever subsection provided the *greater benefit.* See Congressional Committee Reports, Appendix, *infra,* pp. 34-39. See also, 2 Mertens, *Law of Federal Income Taxation* (1964 ed.), Section 12.106a. Petititioner admits that the *entire* amount involved was included in "gross income." The cases cited by it clearly establish that that is, and always was, all that was required. The reference to Section 1016(a)(2) of the Code has no bearing on the issue. That section requires an adjustment to the basis of the *producing property* on account of depletion previously allowed when determining *gain or loss* on the *sale or disposition thereof.* No "loss of property" is involved in this case as petitioner implies. Respondent sold natural gas to customers in the usual course of its trade or business. It did not sell the producing property!

Its "basis" in the gas sold was the cost of producing it. When the sales were made they were final and unequivocal and the proceeds were absolutely subject to tax. Just as depreciation must be taken into consideration with regard to the taxable year "allowed or allowable", regardless of whether it was actually taken on the tax return, respondent was required by law to take its depletion deduction in the taxable years when the gas was produced and sold. A subsequent event, *i.e.,* a lawsuit, in a later year obligated respondent to pay back money. But its mineral was gone. There is no provision of the tax law which permits or requires a *reduction* in a taxpayer's basis on account of the

payment of money. Congress has inserted some sections in the Revenue Code which provide for the adjustment of taxes between years but in the absence of such special legislation each taxable year stands on its own. This has always been the law! This was clearly demonstrated by the Government's position in *Alice Phelan Sullivan Corp.* v. *United States, supra.* See also *Hugoton Production Co.* v. *United States,* 349 F.2d 418 (Ct. Cls. 1965).

Congress has just not legislated the adjustment proposed by petitioner. It had ample opportunity to do so but did not. See Committee Reports, Appendix, *infra.* Petitioner is therefore, asking this Court to legislate such an adjustment.

The case of *O'Meara* v. *Commissioner, supra,* so heavily relied upon by petitioner, does not accord with the numerous Courts of Appeal cases cited by petitioner in its brief (page 16, footnote 5). It is contradictory and inconsistent on its face. The Tax Court there recited the rule of law and then proceeded to ignore it. As the many other cases have stressed, and as Section 1341 specifically states, all that is required is that amounts received under claim of right be included in *gross income*—not taxable income, and there is a substantial difference. Any other rule would depend for its application upon whether the particular taxpayer paid a tax. Two taxpayers otherwise similarly situated might be treated differently depending upon extraneous economic factors peculiar to one or the other.

Of the many, many cases decided under the revenue laws since 1913, *O'Meara* is the *only* case ever cited by petitioner in direct support of its position here—and it was not reviewed by a higher court. Further, in that case the taxpayer had lost title to the entire property. In any event, it cannot be presumed that Congress, in enacting subsection 1341(a)(4) with deliberate care and precision (so as to codify *Healy* and *Lewis* as petitioner admits), intended

that *O'Meara* would apply to the exclusion of all other cases, including those decided by this Court. If the Congress so intended it would have surely said so!

In its brief, petitioner itself distinguishes *Arrowsmith* v. *Commissioner, supra,* when it points out that the amounts were repaid as a consequence of a prior *capital* transaction and, hence, only a capital loss was allowed. As previously pointed out, in the instant case no capital transaction is involved. Respondent was, and is still, selling gas in the ordinary course of business and reporting the proceeds of sale as ordinary income.

Petitioner stresses that when viewed from the "transactional" approach, respondent has been allowed a deduction which exceeds the amount originally taxed. That is also true for any taxpayer who is allowed a depletion or depreciation deduction in one taxable year and in a subsequent year uses the same funds or "cash flow" to pay wages, salaries, overhead or other business expenses. Yet the Government has not challenged those deductions! Such "tracing" of dollars has never been permitted in tax law.

The fallacy here is that petitioner is urging an "open account" theory of depletion, the thrust of which is that the depletion deduction may be adjusted from year to year as facts or economics change. Not only is this not permissible but it is prohibited by law. For example, a taxpayer might produce and sell mineral in a given year and receive no percentage depletion deduction if its production costs were high, because of the fifty percent taxable income limitation provided by Section 613(a). If petitioner's theory were correct a taxpayer should be allowed *additional* percentage depletion in a subsequent year when costs were low and the limitation not operative. But this has never been permitted. Compare, *Fribourg Navigation Co., Inc.* v. *Commissioner,* 383 U.S. 272 (1966). It should be noted that even in *Fribourg* the Government did not attempt to adjust depreciation taken in *prior* years. In addition, Section 1.1016-3(a)(1)(ii) of the Treasury Regulations specifically provides that:

> "The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of the facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years."

D. No double deduction is involved in this case.

The petitioner in its brief invokes the rule of *Ilfeld Co.* v. *Hernandez,* 292 U.S. 62 (1934), which is alleged to be that a taxpayer may not take "more than one deduction" with respect to the same money payment! No such double deduction is involved here! Respondent has taken only *one* deduction for *one* money payment. It took a depletion deduction when its mineral was depleted because in those taxable years it was required to take the deduction or lose it forever. In 1958 it paid out $505,536 and took a deduction for *that* payment. It took two deductions for two economic deprivations— the depletion of its mineral *and* the payment of money. These events took place in separate and distinct taxable years in the course of respondent's trade or business. The case of *United States* v. *Ludey,* 274 U.S. 295 (1927) does not support the proposition for which it is cited by petitioner. Respondent here has not sold its producing real property. If it had, the principle of *Ludey* might be applicable in determining its gain or loss on that sale, but respondent would still have been obliged to pay out $505,536. (Note that *Ludey* was decided prior to the advent of percentage depletion.) Furthermore, *Ludey* specifically held that the depletion deduction to which a "taxpayer was entitled to deduct" under the tax law in the year of production is inviolate thereafter until *the producing property is sold.* The prior years' tax returns cannot be reopened so as to recompute

the tax impact in those years. *United States* v. *Ludey, supra,* at 303-304. In any event, it must be presumed that if Congress, in enacting Section 1341, had intended to apply petitioner's strained interpretation of *Ludey,* again it would have so provided. Respondent is not claiming a capital gain or loss. It sold nothing in 1958 that mitigated the business expense deduction to which it was entitled in 1958. It was "entitled" under the law to the depletion deductions taken in 1952 through 1957. Those deductions may not be disturbed in a subsequent year unless Congress so provides.

Petitioner devotes a substantial portion of its brief to an argument that an adjustment is required by subsection 1341(a)(5) of the Code. Its brief recites (p. 20) that a "policy against double deductions is expressly written into part of Section 1341, with which the present case is most directly concerned." This statement is followed by a quotation from subsection 1341(b)(3) which refers to the amount determined under "subsection (a)(5)". In this case, however, respondent did *not* recompute its *tax* for 1952 through 1957 under subsection (a)(5) of Section 1341. It took a *deduction* under subsection 1341(a)(4). Subsection 1341(a)(5) is not applicable here! To quote again from petitioner's brief (p. 20):

> "Thus Congress emphasized that a taxpayer who chose to make use of the new procedure allowed by *section 1341(a)(5)* could not also lay claim to the equivalent of a double deduction by invoking the rule of *Healy* and *Lewis,* which are codified in section 1341(a)(4)." (Emphasis supplied.)

This is precisely the point! Respondent has always relied upon the "codification" of the rule of *Healy* and *Lewis* in Section 1341(a)(4). The parties have stipulated, always agreed, and rightly so that subsection 1341(a)(4) is the applicable alternative and the Courts below have decided the issue on that basis. Respondent did not determine its "tax" under subsection (a)(5)! Subsection 1341(a)(5)

is not applicable to this case! Petitioner's quotation from the statute serves to further emphasize the alternatives intended by Congress. Presumably, petitioner admits that the issue has been determined correctly under subsection 1341(a)(4) but is asking this Court to hold that the very specific provisions of subsection 1341(a)(5) must be substituted for subsection 1341(a)(4). Congress refused to so legislate and even the Treasury Regulations under Section 1341 have not attempted to implement such a theory for the very reason that Congress specifically said that this may *not* be done.

The fact is that Congress provided two alternatives: (1) a *deduction* for the *amount* paid out in the year paid under the rule of the *Healy* and *Lewis* cases (subsection 1341(a)(4)), *or* (2) a recomputation of *tax* for the prior years by excluding the *amount* from gross income (subsection 1341(a)(5)), whichever results in the *lesser tax*. This is what the Congress said, deliberately and purposefully. Petitioner argues that Congress could not possibly have meant what it unequivocally said. Respondent submits that petitioner's quarrel is with the Congress not with respondent or the decision of the Court below.

E. Petitioner's alternative argument is not sustainable under The Revenue Code or The Case Law.

The alternative adjustment proposed by petitioner in its brief is that upon payment of the $505,536 in 1958, respondent is required to restore to *income* the depletion deduction taken when the equivalent amount was included in gross income in prior years. There are myriad ramifications to this theory. First of all, however, it should be noted that all of the cases cited by petitioner involve a *return* of property, *refund* of amounts previously paid out, *cancellation* of a debt or obligation that had been previously deducted, and all of which resulted in a recognizable *benefit* to the taxpayer *in that taxable year* either because of the receipt of a benefit or the termination of the

business. These cases then merely recite the long-standing "tax benefit rule." In the instant case, however, there was no benefit conferred on respondent by the refund—it *paid out* money. It experienced an *additional* detriment. It did not terminate its operations—they continue to this day. In fact in *Maryland Casualty Co.* v. *United States*, 251 U.S. 342 (1920), cited by petitioner as support of its theory, this Court, after discussing the theory, held:

> "It would not be difficult to suggest conditions under which the statutory permit to deduct net additions to reserve funds would result in double deductions in favor of an insurance company, but such deductions can be restored to income again only where it is clearly shown that subsequent business conditions have *released the amount* of them to the free beneficial use of the company in a real, and not in a mere bookkeeping sense. If this seemingly favorable treatment of insurance companies is to be otherwise corrected or changed, it is for Congress, and not for the courts, to amend the law.
>
> "Since the findings of fact before us do not make the clear showing, which must be required, that the statutory deduction of net reserves in prior years was restored to the *free use* of the claimant in 1913, it should not have been charged as income with the decrease in that year, and, on the record before us, the holding of the Court of Claims must be reversed." (Emphasis supplied.)

The case of *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296 (1946), cited by petitioner, does hold that a *refund* of previously deducted excise taxes constitutes income. It also holds that a taxpayer may *not* defeat the addition to income by claiming by way of equitable recoupment that prior years' taxes were incorrectly determined. So here the Government may not adjust a proper deduction for 1958 on the grounds that the proper depletion for prior years must first be recouped. In any event, it seems clear that equitable recoupment is unavailable as a remedy where Section 1341 applies. See *Estate of Samuel Stein* v. *Commissioner*, 37 T.C. 945 (1962).

L.O. 1032, 2 Cum. Bull. 216, also points out that the "release of reserves" must take place in the taxable year. In the instant case, respondent did not regain the "free use" of its depletion allowance deducted in prior years. It *paid out* $505,536! Its assets were *decreased.* It recovered nothing. Its mineral was still depleted and its money paid out.

The same circumstance serves to distinguish the case of *Douglas* v. *Commissioner,* 322 U.S. 275 (1944), relied upon by petitioner. There the taxpayers received advance royalties upon which they were allowed a depletion deduction. When, in a subsequent year, the *operation was abandoned* with absolutely *no mineral production* ever having been obtained, this Court upheld the validity of a Treasury Regulation which required the inclusion of the depletion deduction in income in the year of *termination or abandonment of the enterprise.* It should be noted that the Treasury Regulation there involved (and still valid) specifically provided that the inclusion in income is *only* required where there has been *no mineral production at all.* The currently effective version of that regulation (Treasury Regulation Sec. 1.612-3(a)(2)), provides that:

> "If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates or is abandoned before there has been *any* income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such *expiration, termination* or *abandonment.*" (Emphasis supplied.)

The Courts have carefully and strictly construed this rule and regulation and have rejected any attempt to include the amount of the prior deduction in income where there has been *any* production at all. *Dolores Crabb* v.

Commissioner, 41 B.T.A. 686 (1940), rev'd on other grounds, 119 F.2d 772 (CA 5th, 1941); *Waggoner* v. *Commissioner*, 47 B.T.A. 699 (1942); Revenue Ruling 68-78, Internal Revenue Bulletin 1968-7, p. 18. In this sense, *Douglas* accords with *United States* v. *Ludey, supra.*

In the instant case, however, respondent was producing the mineral, continues to produce it and there has been no sale of the property, or expiration, termination or abandonment of the lease or enterprise. The plain fact is that all of the rules and theories proposed by petitioner require for their application a "triggering mechanism" that results in a granting to, or release of, a tangible, permanent *benefit* to the taxpayer in the particular taxable year that can be used or otherwise applied for other purposes. That has not happened in the instant case. Respondent has suffered a burden in 1958. It *paid out* money. Until its operations terminate the adequacy of its depletion deductions taken in prior years cannot be redetermined or recalculated, even in the economic sense. That may well have been the very reason Congress did not write the law the way petitioner is asking this Court to read it.

Acceptance of petitioner's arguments could open the door to an almost unlimited number of possible contentions that income must be recognized or deductions disallowed because of factors that could vary in any given year or change the long-term economic impact of what has transpired in the past, thereby destroying the annual accounting concept that has heretofore been the keystone of our revenue laws. If such "open account" or "lifetime" theory of taxation must be applied for the benefit of the Government it must also be made available to taxpayers. If such a dramatic restructuring of the Revenue Code is to be inaugurated it must be done by Congress.

In certain highly restrictive circumstances the Congress has made provision in the Revenue Code for adjustments which recognize long-term economic impact, but those provisions, like Section 1341, are very carefully considered

and technically worded. Even then, in most instances, they only partially alleviate the problem.

The case of *Alice Phelan Sullivan Corp.* v. *United States, supra,* illustrates the point. There the taxpayer had taken a deduction for a charitable contribution in a year when tax rates were low. In a later year the contributed property was *returned* to the taxpayer which, in a classic application of the "tax benefit rule" was required to include the amount deducted at the much higher current tax rates. The result was that the taxpayer paid more tax by the contribution and recapture than if the transaction had never occurred in the first place. Although it recognized the net inequity, the Court of Claims held (at the urging of the Government), that under the law it was powerless to remedy the situation as the Congress had not provided for *tax* equaliziation.

In the instant case, the respondent paid out $505,536 and its mineral was not recovered. It is gone forever. Yet the Government is before this Court contending for an "inverse tax benefit" or "tax equalization" rule that, in *Alice Phelan Sullivan Corp.* it contended did not exist and even though the long-term result of such a rule may effect even greater distortions. It is significant here that the petitioner does not indicate how its "tax equalization" rule would be applied if the taxpayer had received no benefit from the depletion deduction in *any* of the prior years. There cannot be two rules—one for the Government and another for taxpayers. As the Court of Claims said, there may be inequities in the tax law (real or imagined) but they can only be resolved by Congress. See, *Brotherhood of Locomotive Firemen & Enginemen, et al.* v. *Chicago, Rock Island & Pacific Railroad Co.* (United States Supreme Court Nos. 16 and 18, October Term 1968, decided November 18, 1968).

Regardless of the professional and tactical ramifications of the publication of a *proposed* Treasury Regulation after a petition for *certiorari* is filed by the Government in a

case, respondent would ask the Court to note that said proposed Regulation, regardless of its validity, controverts petitioner's alternative argument in this case. Further, it is promulgated under Section 613 of the Revenue Code and makes no reference at all to Section 1341 although its language is strikingly similar and was obviously designed to overrule the decision of the Court below in this case. Although petitioner states that there was "no Treasury Regulation bearing directly on the problem" respondent submits that present Treasury Regulations, Section 1.1341-1(b)(1)(i) promulgated in 1957 does bear directly on the problem and completely supports respondent. While the petitioner disavows reliance upon the *proposed* regulation, it does take pains to stress that its validity "may well turn on the outcome of the instant case." The primary holding of this Court in the *Douglas* case was that a long standing Treasury Regulation which had subsisted from 1919 through the enactment of several revenue acts should be upheld. The same may not be said, however, for the proposed Regulation cited by petitioner. Not only was it promulgated under Section 613, which is not involved here, but its very promulgation at this particular time, when there have been no changes in the depletion provisions of the Code for many years, is highly significant. Furthermore, it usurps the province of Section 1341, especially subsection (a)(4) thereof, under which the Treasury has apparently not felt authorized nor called upon to promulgate such a regulation since the inception of the section in 1954.

In the final analysis then the proposed Regulation under Section 613 is absolutely inconsistent with Regulations, Section 1.1341-1(b)(1)(i) and thus, the Treasury itself proposes to subvert its own Regulation. Petitioner at the same time, is asking this Court to strike down a longstanding promulgated Regulation, support the *proposed* one, while at the same time citing *Douglas* for the proposition that this should not be done.

This so-called "clarifying" proposed Regulation is decidedly unusual in that it was promulgated when the decision by the Court of Appeals in this case represented the outstanding law on the question. Finally, as pointed out herein, the depletion deduction to which a taxpayer was entitled in prior years has no bearing on amounts paid out in a current year which are unrelated to the proper depletion deduction in such year.

CONCLUSION

The judgment of the Court below should be affirmed.

Respectfully submitted,

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APPENDIX

INTERNAL REVENUE CODE OF 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(26 U.S.C. 162.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) General Rule.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * *

(b) Special Rules.—

(1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility (as defined in section

7701(a)(33) without regard to the limitation contained in the last two sentences thereof) if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. This paragraph shall not apply if the deduction arises out of payments or repayments made pursuant to a price redetermination provision in a subcontract entered into before January 1, 1958, between persons other than those bearing the relationship set forth in section 267(b), if the subcontract containing the price redetermination provision is subject to statutory renegotiation and section 1481 (relating to mitigation of effect of renegotiation of Government contracts) does not apply to such payment or repayment solely because such payment or repayment is not paid or repaid to the United States or any agency thereof.

* * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.1341-1—*Restoration of amounts received or accrued under claim of right.*— (a) *In general.*—

(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item,

and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

* * *

(b) *Determination of tax.*— (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable.

* * *

(26 C.F.R. 1.1341-1)

Congressional Committee Reports

HOUSE REPORT No. 1337, 83D CONGRESS, 2D SESSION (1954), pp. 86, 87.

D. Claim of Right (sec. 1341)

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The committee's bill provides that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount re-

paid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with smaller amounts, excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution.

HOUSE REPORT No. 1337, 83D CONGRESS, 2D SESSION (1954), PP. A294, A295.

PART V—CLAIM OF RIGHT

SECTION 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayer does not lose his unrestricted right to the money. The section is

specifically made inapplicable to sales of inventory, stock in trade, etc. An accrual basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U.S. 6 (1952)). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.

SENATE REPORT NO. 1622, 83D CONGRESS, 2D SESSION (1954), P. 118.

D. CLAIM OF RIGHT (sec. 1341).

(1) House changes accepted by committee.

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The House and your committee's bill provide that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with amounts of $3,000 or under, the effect of excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution. This section is inapplicable to refunds, allowances, bad debts, etc., pertaining to sales of inventory or stock in trade which may be provided for under section 462 relating to reserves.

(2) Change made by committee.

Your committee's bill provides that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility where the refunds are required to be made by the regulatory body, such as the Federal Power Commission. It is made clear, for example, that refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

SENATE REPORT No. 1622, 83D CONGRESS, 2D SESSION (1954), PP. 451, 452.

PART V—CLAIM OF RIGHT

SECTION 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

Except for one revision this section corresponds to section 1341 of the House bill.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a por-

tion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayers does not lose his unrestricted right to the money. This section is specifically made inapplicable to sales of inventory, stock in trade, except refunds made by a regulated public utility in certain cases. An accrual-basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462.

Your committee has provided that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility (as defined in sec. 1503 (c)) if such refunds or repayments are required to be made by the government, political subdivision, agency or instrumentality referred to in such section. Thus refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U.S. 6 (1952)).

Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.